MARGARET LUPING & ORS

v.

KETUA PENGARAH HASIL DALAM NEGERI

COURT OF APPEAL, KUALA LUMPUR
GOPAL SRI RAM JCA
SITI NORMA YAAKOB JCA
MOKHTAR SIDIN JCA
[CIVIL APPEAL NO: S-01-305-96]
3 JANUARY 2000

REVENUE LAW: *Income Tax - Appeal against assessments - Deduction - Whether "net proceeds" paid to state government deductible from assessments - Calculation of income during basis period - Whether includes future income - Whether payments were revenue expenditure or capital expenditure - Whether barred by s. 39(1)(a) of Income Tax Act 1967 - Whether payment to state government includes payment to special fund - Income Tax Act 1967, ss. 33(1), 39(1)*

WORDS AND PHRASES: *"net proceeds" - Meaning of*

The appellants were holders of a timber license granted by the Sabah state government. As a compulsory requirement, all license holders were required to pay "net proceeds" to the state government on extraction of timber.

The appellants claimed that the amount paid as net proceeds to the state government should be allowable deductions under ss. 33(1) and 39(1) of the Income Tax Act 1967 ('the Act'). The Special Commissioners of Income Tax, in affirming the respondent's assessment, considered the net proceeds as net profits and held that they were not deductible. The respondent further submitted that the net proceeds were capital expenditure and were barred by s. 39(1) of the Act from being deductible because they were payable by the state government into a special fund instead of being retained by the state government.

The appellants' appeal to the High Court was dismissed and they appealed to the Court of Appeal.

Held:
Per Mokhtar Sidin JCA

[1] For a taxpayer to qualify for deduction of any expenditure incurred by him, he must first ascertain that the expenditure is an allowable deduction under s. 33 of the Act. Once that is ascertained, he has to find out if the expenditure is barred by the provisions of s. 39(1) of the Act from being so deductible.

[2] The net proceeds in the present case were something unique to the State of Sabah used to describe payments made by the licensees for the extraction of commercial timber under the licenses given to them.

[3] The net proceeds payment was a compulsory condition imposed in granting the timber license. They were outgoings and expenses wholly and exclusively incurred during that period for the production of gross income from timber operations and hence qualified for deductions under s. 33(1) of the Act.

[4] In revenue law, any income or expenditure must be viewed in that year of assessment. Whether the appellants were eligible to get the net proceeds back in the future was irrelevant. If the payments were to be refunded to the appellants they would be treated as income received in the year the appellants received them.

[5] The net proceeds payments were not for acquiring an interest in land or the purchase of standing timber or acquiring land with the right to extract timber on it. They were incurred for the extraction of timber and as such they were revenue expenditure and not capital expenditure.

[6] The payment was not caught under s. 39(1)(g) of the Act because whether the state government kepts the money or for what purpose the money was used was irrelevant as long as the money was paid to the state.

[Appeal allowed.]

Case(s) referred to:

Ampat Tin Dredging Ltd v. Director General of Inland Revenue [1982] 2 MLJ 46 ***(refd)***

Director-General of Inland Revenue v. Hup Cheong Timber (Labis) Sdn Bhd [1985] 2 CLJ 202 ***(foll)***

Director-General of Inland Revenue v. LTS [1974] 1 MLJ 187 ***(refd)***

Harris (Surveyor of Taxes) v. Corporation of Burgh of Irvine 4 TC 221 ***(not foll)***

Henrikson v. Grafton Hotel Co Ltd [1942] 2 KB 194 ***(not foll)***

Mersey Docks and Harbour Board v. Lucas I TC 385 ***(not foll)***

Rutter v. Charles Sharpe & Co Ltd 53 TC 163 ***(refd)***

Vallambrosa Rubber Co Ltd v. Farmer 5 TC 529 ***(refd)***

Legislation referred to:

Income Tax Act 1967, ss. 33(1), 39(1)

Supplementary Income Tax Act 1967, ss. 3(1), 19, 21

For the appellants - Herman Luping; M/s Luping & Co

For the respondent - Ahmad Khairuddin Abdullah

[Appeal from High Court, Kota Kinabalu; Tax Appeal No: K-16-01-1995]

Reported by Yow Ting Fong

JUDGMENT

Mokhtar Sidin JCA:

We had given our decision in respect of this appeal earlier whereby we allowed the appeal by the appellants. We now give our reasons for doing so.

The appellants, being unhappy with the assessments raised by the respondent, appealed against those assessments to the special commissioners. Before the special commissioners there were two separate appeals but were heard together because the issue was the same in both appeals. The appeals continued to be heard together in the High Court. The first appeal was by Syarikat Jasa Bumi (Woods) Sdn Bhd while the second appeal was by Margaret Luping and two others. The appellant in the first appeal did not appeal to this court. As such the appeal before us is the one by Margaret Luping and two others.

As can be seen from the record of appeal, both the special commissioners and the High Court judge at Kota Kinabalu treated the facts of these two appeals as one. There were times in the case stated and in the judgment of the learned High Court judge where reference to one appeal covered the other appeal as well.

The appeal by Margaret Luping and two others were against the following additional assessments raised by the respondent:

Year of Assessment	Date of Assessment	Tax Payable
1974	10.9.1977	RM15,580.00
1976	10.9.1977	RM19,599.00

As can be seen from the above the additional assessments for the years of assessment 1974 and 1976 were raised on 10 September 1977. The tax payable for those years was in respect of sums paid to the state government of Sabah as net proceeds. The appellants claimed that the amounts paid to the state government should be allowable deductions under ss. 33(1) and 39(1) of the Income Tax Act 1967 (hereinafter referred to as "the Act").

The respondent disagreed, and added back the sums paid as net proceeds to the state government. As a result of the adding back, the tax payable on those sums are those stated above.

The special commissioners found that the timber licence granted to the appellants required the appellants to pay net proceeds to the state government on extraction of timber. The net proceeds were calculated by

taking into account extraction costs, royalty and other fees. The average FOB value of timber exported minus total cost was said to be the net proceeds. The net proceeds were levied and included in royalty bills as and when timber were extracted. Generally, it was based on the volume of timber removed. It was the policy of the State Government then in order to encourage development that a person paying the net proceeds was entitled to get back the net proceeds paid by him as subsidy for any agricultural or industrial development carried out by him on the land where the timber were extracted.

The issue before us is whether the net proceeds paid are allowable as deductions under s. 33(1) of the Act and not caught by s. 39 of the Act. Section 33(1) of the Act provides as follows:

33. ADJUSTED INCOME GENERALLY

(1) Subject to this Act, the adjusted income of a person *from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred* during that period by that person in the production of gross income from that source, ... (emphasis made).

The relevant provisions of s. 39(1) in respect of this appeal provide as follows:

39. DEDUCTIONS NOT ALLOWED

(1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of:

(a) ...

(b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of producing the gross income;

(c) any capital withdrawn or any sum employed or intended to be employed as capital;

(d) ...

(e) ...

(f) ...

(g) any sum, **by whatever name called,** payable (otherwise than to a State Government or with the approval of the Minister, a statutory authority, or other body the capital or fund of which is wholly or substantially owned by a State Government or a statutory authority) for the use of a licence or permit to extract timber from a forest in Malaysia;

(h) ...

(i) ...

(j) ...

(k) ...

(l) ...

(m) ...

(2) It is hereby declared that section 33, except in so far as it relates to expenses of the kind specified in subsection (1)(a) to (d) thereof, is not an express provision of this Act within the meaning of this section. (emphasis added)

The relationship of these two sections as correctly pointed out by the special commissioners is found in the case of *Director-General of Inland Revenue v. Rakyat Berjaya Sdn Bhd* [1984] 1 MLJ 248. At pp. 253 and 254 Lee Hun Hoe, CJ (as he then was) said:

> The relationship between the deduction allowing provisions of s. 33 and the deductions disallowing provisions of s. 39 is explained by Chang Min Tat J, as he then was, in *DGIR v. LTS* [1974] 1 MLJ 187. To be deductible a payment must (i) be authorised as a deduction by s. 33(1), and (ii) not be disallowed by s. 39. The Taxpayer accepts that, if the interest payments were, as it contends, outgoings or expenses wholly and exclusively laid out in the production of income from its timber trade so as to comply with s. 33(1), it would still fail to obtain relief if the interest payments were also caught by any of the disallowing provisions of s. 39.

The case of *Director-General of Inland Revenue v. LTS* [1974] 1 MLJ 187, cited in the decision above, was a case where the taxpayer was a transferee of the permit holders for the extraction of timber. There were two issues raised in that case. Firstly, whether the sums paid to the Government of Kedah as royalties for the extraction of timber and secondly, whether the sums paid as commissions for the user of the permits, were deductible as being outgoings or expenses wholly and exclusively incurred by the taxpayer in the production of his gross income. In his judgment at pp. 188 and 189 Chang Min Tat, J (as he then was) said:

> In respect of the royalties paid to Government, the answer is fairly simple. If I remind myself that the assessment of the chargeable income of any person is to be determined within the four corners of the statute, ...
>
> On the concession of Revenue which if I may say with respect, is in my opinion entirely correct, the royalties are clearly outgoings and expense wholly and exclusively incurred within s. 33(1) of the Act and therefore allowable as deductions.
>
> The matter of the commissions paid by the taxpayer to the permit-holders is perhaps a little more difficult in the absence of any concession by Revenue. It involves the interpretation of s. 39 read, as it must be, in conjunction with s. 33 ...
>
> With the greatest respect, I find some difficulty in fully comprehending the meaning and the logic of the view taken by the Special Commissioners. Section 39 refers to deductions that are not allowed. Subsection (1) specifies such deductions. They include in sub-section (g) any sum payable otherwise than to a State Government for the use of a licence or permit. Sub-section (2) must with respect mean that the deductions allowed in s. 33 as expenses wholly and exclusively incurred do not extend to the expenditure mentioned in sub-sub-sections 39(1)(a) to (g).
>
> It therefore means that the sum paid by the taxpayer to the permit holders is caught by subsection (1)(g) of section 39 and is not deductible.
>
> It also means that the sum paid to the Government of the State of Kedah in respect of the royalties is deductible under the relief provided in 'otherwise than to a State Government' in this subsection, as rightly conceded by Revenue.

In our view, for a taxpayer to qualify for deduction of any payment or expenditure incurred by him he must first of all place the payment or expenditure as allowable under s. 33 of the Act. He has to justify that the payment or the expenditure incurred by him is an allowable deduction under s. 33 of the Act. In the present appeal it is sub-s. (1) of that section. If the payment or expenditure is not allowed under s. 33(1) of the Act then it would not be allowed as a deduction. On the other hand, if it is allowed as a deduction under s. 33(1) of the Act, one has to proceed to the next step to ascertain whether the payment is caught under s. 39(1) of the Act. If it is caught under s. 39(1) of the Act, then it would not be allowed as a deduction though it is allowable under s. 33(1) of the Act.

It is in this light that we now examine whether the net proceeds can be allowed as deductions to determine the adjusted income of a person. In our view, the special commissioners in the present appeal had applied the test we have stated above. With the greatest respect to the learned judge, we feel that he was confused when he considered the net proceeds under ss. 33(1) and 39(1) simultaneously.

Let us examine the net proceeds made by the appellants in the light of the test stated above. The special commissioners found that it was a requirement under the timber licence that the appellants pay the state government of Sabah the net proceeds as stated in the schedule which was according to the size of the trees extracted. The net proceeds payments were peculiar only to the state of Sabah. Had the appellants refused to pay the net proceeds they would not be granted the timber licence or the timber licence granted would be withdrawn. It was a compulsory condition imposed in granting the timber licence. The net proceeds payments were stopped in 1979.

As can be seen from the record the net proceeds payments was a policy adopted by the state government of Sabah in order to encourage agricultural development or to encourage re-forestation on the land from which timber had been extracted. For the said reason the net proceeds were kept in a special fund whereby any person including the person who had extracted timber on the said land can apply for the money kept in that fund to be released to him to be used for agricultural development such as planting of rubber and oil palm trees on the said land. There was no guarantee that such net proceeds would be refunded to the person who made the payments, because he would not be entitled to the refund if he did not carry out any agricultural development on the land from where the timber was extracted.

(1) Whether The Net Proceeds Payments Are Allowable Deductions Under Section 33(1) Of The Act

The question for us to consider is whether the net proceeds paid by the appellants to the state government are allowable deductions under s. 33(1) of the Act.

Counsel for the respondent admitted that the net proceeds payments were a condition attached to the timber licence, something like a royalty. The special commissioners in the case stated:

> The timber licence granted to the appellants requires them to pay the net proceeds to the State Government which they are eligible to get back as subsidy for agriculture and industrial development purposes. In accordance with the requirement of the licence they made the requisite payment to the State Government ...

The special commissioners in interpreting net proceeds appeared to consider the net proceeds as net profits and cited several English authorities in respect of this: (*Henrikson v. Grafton Hotel Co Ltd* [1942] 2 KB 194; *Harris (Surveyor of Taxes) v. Corporation of Burgh of Irvine* 4 TC 221 and *Mersey Docks and Harbour Board v. Lucas* 1 TC 385). We are of

the view that those cases are not applicable here. We have pointed earlier on that the net proceeds in the present appeal was something peculiar to the state of Sabah. It was not the normal net proceeds as enumerated in those cases. For that purpose it is appropriate to consider what the state of Sabah meant by net proceeds for which a person who was given a timber licence was asked to pay. The meaning of net proceeds as found in the exhibit produced before the special commissioners states as follows:

NET PROCEEDS

The State Government of Sabah in June 1978 introduced a policy to encourage and assist genuine developers in the development of land for agricultural purpose in the State. The policy involves the financing of the development from the proceeds of timber. This policy is known as the New Land Alienation Policy is contained in MNRC. 103/8/1/278 dated 7 June 1968.

2. In granting timber licences to individuals or companies the State requires an account known as "Net Proceeds" to be paid into an account known as "the Land Alienation Deposit Account" to be used for such development. The amount payable took into account the estimates of average volume per acre of commercial timber (by regions and each Forest District), log prices and assumes logging costs within each region. The rates differ from district to district.

3. The release of the monies were made for payment of development expenses in accordance with the approved development plan. Such releases were approved by the Ministry of Agriculture and Fisheries on a satisfactory report submitted by the Director of Agriculture; the release of "Net Proceeds" from the account is within the entire discretion of the Government.

4 ...

5 ...

6 ...

7. Despite the fact that the trust accounts are in the joint names of the Government and licensees, the Government has always treated those monies as Government monies; the names are merely for the purpose of identification related to the land title and development.

This exhibit clearly shows that the net proceeds in the present appeal are not the net proceeds as defined by the decided cases cited by the special commissioners. The net proceeds here are something unique to the state of Sabah and it was only a label given to those payments made by the licensees for the extraction of commercial timber under those licences given to them. It must be remembered that at that time the main source of revenue for the state was timber. This was what the special commissioners

in the case of *DGIR v. Syarikat United Sabah Developments & Industrial Sdn Bhd* (Rayuan PKR 222) had identified. The special commissioners in that case went on to deal with that case in accordance with the Act. Though that case is not directly on point with the present appeal we are of the same view that this case should be dealt with directly under the Act.

It is not disputed that the appellants in the present appeal derived their income from timber operations. Timber operations have been defined in s. 19 of the Supplementary Income Tax Act 1967 (Act 54):

> 19. In this Part (i.e. Part IV headed Timber Profits Tax), unless the context otherwise requires:
>
> 'timber operations' means the extraction of timber from a forest in Malaysia or the granting or assignment of any rights, privileges, licences or concessions (by whatever name called) for the extraction of such timber but does not include the processing, milling, sawing or manufacturing of the timber.
>
> 'income derived from timber operations' includes all premiums, rents and tributes (by whatever name called) derived from timber operations, or from the granting or assignment of any rights, privileges, licences, or concessions (by whatever name called) for the extraction of timber from a forest in Malaysia;

The question is whether the net proceeds were allowable deductions under s. 33(1) of the Act. We called upon counsel for the respondent to address us on this issue. We did so because we are of the view that the special commissioners came to the wrong conclusion when they held that they were not allowable deductions under s. 33(1) of the Act. We are of the view that when the special commissioners equated the net proceeds here as being net proceeds under the English law they were on the wrong track. As we have said earlier the net proceeds was a special label given by the state of Sabah for payments made to a special fund by the holder of timber licence to extract timber. It is in this light one has to consider whether the payment made by the holder of the licence was allowable as a deduction under s. 33(1) of the Act. We are of the view that the special commissioners had erred when they said:

> On the facts of the appeal before us there was no question of services being provided; it was merely a certain sum becoming payable. The net proceeds were not paid for the purpose of earning the profits although they arise out of and are connected with the trade. In order for an expenditure to be deductible as having been wholly and exclusively incurred in the production of income it is not enough that the disbursement is made in the course of, or arises out

> of, or is connected with, the trade or is made out of the profits of the trade. It must be made for the purpose of earning the profits (see *Strong & Co of Romsey Ltd v. Woodfield* [1906] AC 448).

Clearly to us, the special commissioners had not considered the payment under s. 33(1) of the Act. They had ignored s. 19 of the Supplementary Income Tax Act 1967 (Act 54) where specific provisions had been enacted specially to give special meaning to the words "timber operations", "income derived from timber operations" and "relevant business". There is no doubt and conceded by all parties that the disputed amount arose from timber profit. We do not see any reason why the Supplementary Income Tax Act 1967 (Act 54) was totally ignored by all parties. Section 3(1) of the Supplementary Income Tax Act 1967 states:

> 3. Application of this Act with the Principal Act (1)
>
> Each supplementary income tax imposed by a Part of this Act shall be ascertained in accordance with that Part but, save as otherwise provided in that Part and subject to subsection (2), the principal Act shall apply (with any necessary modifications) for all purposes to supplementary income tax as it does to income tax chargeable under the principal Act.

The principal Act stated in s. 3(1) is the Act. Section 21 of the Supplementary Act determines the timber profit from timber operations. There is no necessity to determine it under any other law. Once it is brought as a chargeable income under s. 33 of the Act, it is deemed to be income from timber operations and there is no question whether it is net profits or otherwise. From the evidence it is clear that when the parties concerned brought s. 33 of the Act into play they had conceded that the income which was in dispute was income from timber operations. Since that income had been brought under s. 33 we have to determine whether the net proceeds should be allowed as deductions under s. 33(1), that is whether they were outgoings and expenses wholly and exclusively incurred during that period for the production of gross income. It is in this respect that the special commissioners had erred when they relied heavily on the fact that the appellants were eligible to have the net proceeds paid back to them if they carried out developments on the land.

In our view whether the appellants were eligible to get the net proceeds in the future is not important. The relevant requirement is whether at the time when the gross income was produced, the net proceeds were expenditure wholly and exclusively incurred in the production of that gross income. In this respect we are of the view that the learned judge was correct when he said:

> However, and I agree with Mr Woodhull, the Special Commissioners, even though they have reminded themselves the issue is deductibility under s. 33, had talked about "profitability", which is not the issue, instead of considering whether that payment is an expense incurred wholly and exclusively in the production of the gross income. Nevertheless, I am of the view that the facts of this case justify the conclusion that it was not an expense incurred wholly and exclusively for earning the profit ...
>
> Therefore, we are still left with the question of whether the payments were incurred wholly and exclusively for producing the gross income. In this regard, and I agree with Mr Woodhull, the Special Commissioners appeared to have strayed when they took into account cases concerning the payment of expenses after the profits had been ascertained and surplus income which were not deductible, ...

Despite stating the correct principle, we find that the learned judge fell into the same error as the special commissioners when he relied heavily on the fact that the appellants would be eligible to get the payments if they carried out development on the said land. (In the present appeal it was conceded by the respondent that the net proceeds were never returned to the appellants). We are of the view that the learned judge had erred when he said:

> Again Mr. Woodhull had lumped royalties, extraction charges and net proceeds together as bearing the same characteristic and therefore to be treated similarly. But, as I have already said, there is a very important distinction between the payment of net proceeds and the payment of royalties and extraction charge and that is in the case of net proceeds the money can come back to the payor if he develops the land while the other payments are irreversibly revenue of the government to which the payor has no claim. The only obstacle to getting the net proceeds back is the payor's failure to develop the land. However, the fact that the payor may fail because of his own fault (in not developing the land) to get the net proceeds back cannot change the fact that the net proceeds were intended to be returned to the payor, by whatever name it is then called. Thus, payment of net proceeds, cannot be regarded as an expense within the meaning of s. 33 because the very money can go back to the payor.

With the greatest respect to the learned judge and the special commissioners we are of the view that they have erred when they approached the question of allowable deduction that way. They misunderstood the scheme under the income tax. It must be remembered that under the tax law, any income or expenditure must be viewed in that year of assessment which is called the basis period. It is in this basis period that the income or the expenditure ought to be considered and calculated. Thus if a taxpayer takes a loan for his business and pays interest for that loan he is entitled to claim deductions for the interest that he has paid in

that year. He is not entitled to claim deductions for interests to be paid in future or coming years even though it could easily be calculated. The deductions for the payments of interests in the future or coming years would only be allowed in the basis period when the payments are made. That was what the special commissioners and the learned judge intended to do in the present case. In our view if the net proceeds payments are to be paid to the appellants those payments would be treated as income received in the year the appellants received them. They have to pay tax for the income they received in that year.

In our view, the correct approach is, any payment made by a taxpayer claimed by him to be allowable deduction should be payments incurred by him in that year of assessment against the gross income received by him in that year. The claim for deductions should be considered in that year of assessment whether the payments were wholly and exclusively incurred in the production of the gross income in that year. It is in this light we have to examine the net proceeds payments made by the appellants: whether they are allowable deductions under s. 33(1) of the Act.

Counsel for the respondent conceded that if the appellants were not willing to make these payments they would not be given the timber licence or if they had been given the timber licence but failed to make the payments the licence would be withdrawn. The net proceeds payments were somewhat similar to royalty payments. In our view the net proceeds payments were a requirement under the licence whereby the appellants were compelled to make those payments. The taxable income of the appellants in the present appeal came from the timber operations for which the appellants were given the licence. Without the licence there would be no income from the timber operations upon which the respondent could raise the tax. In that context we find that the net proceeds payments were wholly and exclusively incurred in the productions of the appellants' income from timber operations. As such they were allowable deductions under s. 33(1) of the Act.

In *Ampat Tin Dredging Ltd v. Director General of Inland Revenue* [1982] 2 MLJ 46, Mohamed Azmi, J (as he then was) at p. 48 said:

> In this case, we are dealing with the provision of section 33(1) of Income Tax Act 1967, the relevant parts of which read:
>
> > Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source ...

As I have occasion to state in the past that it is a well settled principle of law that the the rule of strict construction must be applied in interpretation of statutes which impose pecuniary burden on the subject. If a statute professes to impose a charge, "the rule", said the Judicial Committee in *Oriental Bank v. Wright* is "that the intention to impose a charge upon a subject must be shown by clear and unambiguous language". In *Partington v. Attorney-General*, Lord Cairns said:

> I am not at all sure that, in a case of this kind-a fiscal case-form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.

It is also appropriate to refer to the often quoted words of Rowlatt J in *Cape Brandy Syndicate v. Inland Revenue Commissioner*s:

> ... in a taxing Act clear words are necessary to tax the subject. But it is often endeavoured to give to that maxim a wide and fanciful construction. It does not mean that words are to be unduly restricted against the Crown or that there is to be any discrimination against the Crown in such Acts. It means this, I think; it means that in taxation you have to look simply at what is clearly said. There is no room for any intendment; there is no equity about a tax: there is no presumption as to a tax; you read nothing in; you imply nothing, but you look fairly at what is said and at what is said clearly and that is the tax.

Applying the above principles of construction of fiscal legislation to the present case, there should be no room for doubt as to what s. 33(1) Income Tax Act 1967 requires, as regards deductions that can be made in ascertaining a taxpayer's adjusted income from a source for a particular taxing year. From the clear words of s. 33(1), in order for outgoings and expenses to be allowed as deductions they must be wholly and exclusively incurred in the production of gross income ...

(2) Capital Or Revenue Expenditure

Counsel for the respondent submitted that though the payments were incurred in the production of income, they were capital expenditure and as such not allowed to be deducted under s. 33 of the Act. It was submitted that the payments made created intangible assets for the appellants and as such they were capital expenditure in nature. He cited the cases of *Rutter*

v. Charles Sharpe & Co Ltd 53 TC 163 and *Vallambrosa Rubber Co Ltd v. Farmer* 5 TC 529. The two cases clearly show that the determination of whether a payment is of capital or revenue depends on the circumstances and facts of each individual case. In *Vallambrosa Rubber Co Ltd v. Farmer* 5 TC 529 at p. 536 the Lord President stated the criteria as follows:

> ... Now, I don't say that this consideration is absolutely final or determinative, but in a rough way I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year. Therefore *prima facie* weeding, which does occur every year, seems to me to be an income expenditure.

In the present appeal the payments had been imposed every time timber extractions were done depending on the size of each timber extracted. We agree with counsel for the respondent that the net proceeds were not royalties. Though they were not royalties, the payments were somewhat similar to royalties in the sense that the payments to be made depended on the extracted timber from the concession. It is clear that the payments did not create any intangible asset. They were incurred to produce income. Section 19 of the Supplementary Income Tax Act 1967 (Act 54) in the definition of "income derived from timber operations" provides as follows:

> 'income derived from timber operations' includes all premiums, rents and tributes (by what ever name called) derived from timber operations, or from the granting or assignment of any rights, privileges, licences, or concessions (by whatever name called) for the extraction of timber from a forest in Malaysia;

The Federal Court in *Director-General of Inland Revenue v. Hup Cheong Timber (Labis) Sdn Bhd* [1985] 2 MLJ 322 made a distinction between revenue expenditure and capital expenditure in a timber operation business within the meaning of s. 33(1) of the Act. Briefly, the facts of that case were that the respondent entered into an agreement with Persatuan Peladang Negeri Johor whereby the Persatuan granted to the respondent the exclusive right to work out, fell, exploit and extract timber on a certain piece of land in consideration of the sum of $1,400,000 to be paid by the respondent. The respondent claimed a deduction of that sum from its income but this was disallowed. One of the grounds for disallowing the deduction was that this was a capital expenditure. Wan Hamzah, SCJ (as he then was) when delivering the judgment of the court at p. 327 said:

> As already stated, the other issue in this case is whether the payment was a capital or a revenue expenditure. Relating to this issue several decided cases were cited to us for the Revenue and for the taxpayer. Some of the cases cited were cases of acquiring right to extract timber, some were cases of acquisition of land with the right to extract the timber thereon and some were cases of outright purchase of standing timber. Bearing in mind that the present case is not a case of outright purchase of standing timber but one of acquiring the right to extract timber, ...

His Lordship then went to examine the various authorities and at p. 331 he said:

> We find a number of features in the instant case which point to the conclusion that the sum of $1,400,000 incurred and paid by the taxpayer was revenue expenditure. Reading Clauses 3 and 7 together with the schedule in Appendix A as extracted above, we find that the taxpayer had to commence timber felling and extraction operations soon after March 29, 1973 (the date of the licence to extract timber), and to complete such operations in the first 2,000 acres not later than March 29, 1974, in the next 2,000 acres in 1975 and in the last 1,500 acres in 1976. So the period for extraction and removal was short just as in *Mohanlal's* case. The instant case was not one in which the taxpayer acquired an interest in the land or the taxpayer could wait for a long or an indefinite time before felling, or the taxpayer could allow the trees to grow on the land deriving sustenance and nutriment from it until they became right for felling, as in *Hood Barrs'* case or the case of *Kauri Timber*. Under the agreement in the instant case the taxpayer's obligation was to complete the felling and extraction of timber within a period of less than four years from 1973 to 1976. Similar to *Mohanlal's* case the present case was a case of implied right of the taxpayer to appropriate the timber on felling the trees and extracting them, and just as in *Hopwood's* case the taxpayer acquired proprietary interest in all the trees on the land, not in trees to be selected, because under the agreement no selection of trees was to be done as in *Hood Earr's* case but the taxpayer had to fell and remove all trees. It appears that the land had to be swept clean of all trees and other vegetation in order to prepare for the planting of oil palm and pepper. There is no doubt that the taxpayer was carrying on the business of dealing in timber. This is shown by the statements of accounts of the taxpayer included in the Agreed Bundle of Documents. It incurred an expenditure of $1,400,000 and thereby acquired a ready source of instant supply of stock-in-trade, i.e. timber, which was utilised within a short period. The expenditure was thus incurred on revenue account.

Applying the principle as stated by his Lordship in that case we are of the view that the payments made by the appellants were revenue in nature. The payments were not done to acquire an interest on the land or the purchase of standing timber or the acquisition of land with the right to extract the timber on it. These payments were made for the extraction of timber. We are of the view that the payments were revenue in nature.

(3) Whether Payments Are Disallowed Under Section 39(1)(g) Of The Act

It was the contention of the respondent that even if the payments were allowable deductions under s. 33(1) of the Act, they were payments caught under s. 39(1) of the Act and as such should not be allowable deductions. special commissioners in the case stated said:

> The issue for determination in this appeal is whether the net proceeds which the appellants paid to the State Government in accordance with the conditions in the timber licence granted to them is an allowable deduction within the meaning of s. 33(1) of the Income Tax Act 1967 read with section 39(1)(g) of the same Act ...
>
> Before we proceed any further we shall consider the relationship between both these sections. Section 33(1) deals with deductions which are allowed while s. 39 refers to deductions which are not allowed. On the relationship between these two sections Lee Hun Hoe CJ Borneo said in *Director-General of Inland Revenue v. Rakyat Berjaya Sdn Bhd* [1984] 1 MLJ 248 at p. 254.
>
> > To be deductible a payment must (i) be authorised as a deduction by section 33(1), and (ii) not be disallowed by s. 39.
>
> The inter-relation between these two sections is consistent with law and logic. Section 39 seeks to disallow certain items of expenditure which have been allowed by s. 33(1).

We agree entirely with what had been said by the special commissioners. Having stated the principle correctly, the special commissioners approached the issue differently. We found from the record that the special commissioners had approached the issue wrongly when they considered the deductions under both sections simultaneously and not in sequence.

As we have stated earlier the correct approach is to consider whether the payments are allowable deductions under s. 33(1). If they were not allowed under s. 33(1) then that is the end of the matter. On the other hand, if they were allowable deductions under s. 33(1) of the Act, we have to proceed to examine whether the payments were caught under s. 39(1) of the Act in particular, for the purpose of this appeal, s. 39(1)(g) of the Act. We have found that the payments were wholly and exclusively incurred in the production of gross income and not an expenditure of a capital nature whereby permitting them to be allowable deductions under s. 33(1) of the Act. The next question, were the payments caught under s. 39(1)(g)? Section 39(1)(g) of the Act provides:

39. DEDUCTIONS NOT ALLOWED

(1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of:

(g) any sum, **by whatever name called,** payable (otherwise than to a State Government or with the approval of the Minister, a statutory authority, or other body the capital or fund of which is wholly or substantially owned by a State Government or a statutory authority) for the use of a licence or permit to extract timber from a forest in Malaysia; (emphasis added)

This section makes it clear that any payment by a person for the use of a licence or permit to extract timber from a forest in Malaysia is not allowed to be deducted from the gross income of that person from timber operations unless the payment to a state government or with the approval of the Minister, a statutory authority or body, the capital or fund of which is wholly or substantially owned by a state government or a statutory authority. We consider the payments to a state government or statutory body as the exceptions. Section 39(1)(g) was enacted to prevent the "Ali Baba" practice which was prevalent at that time whereby a timber licence to extract timber was given to a person but instead of extracting the timber himself he allowed the licence to be used by a third party on payment of certain sum. The payment made though incurred in the production of income would not be allowed to be deducted in adjusting the income of the third party from timber operations.

Were the payments made fell within the exception? It was contended by the respondent that though the payments were made to the state government, they were placed in a special fund created by the state. The respondent went at great length to explain the establishment of this fund. Respondent claimed that the fund was specially created so that when a person making the payments carried out development on the land where timber were extracted he is eligible to have the money refunded to him as a subsidy. From our reading of the Act, in particular s. 39(1)(g), it does not matter where the state keeps the money or for what purpose the money is used. We are only concerned to whom the money is paid by the taxpayer. lf it is to the state or to a statutory authority approved by the Minister then the payment comes within the exception. It does not matter to which fund the money is placed. In the present appeal it is not disputed that the payments were made to the state government. As such the payments came within the exception and not caught under s. 39(1)(g). As such the appellants were entitled to deduct the payments from the gross

income under s. 33(1) of the Act. What happened to the payments which were made to the state government is not our concern just like payments under a legal or illegal agreement is not the concern of the court as stated in the case of *Director-General of Inland Revenue v. LTS* [1975] 2 MLJ 30.

Before concluding, there was a point taken by the respondent in the High Court, that the court has no jurisdiction to entertain the appeal for non-compliance of cls. 34 and 35 of sch. 5 to the Act. First of all it is only procedural since it is only the mechanism of putting this appeal into motion in the court. Apparently from the record the learned trial judge did not decide on it though the respondent submitted on this. The respondent did not appeal against this and as such it is a non-issue.

Conclusion

For the above reasons we are of the view that the appeal shall be allowed. The respondent is to amend the assessments for the relevant years to reflect the net proceeds payments be allowable deductions under s. 33(1) of the Act. The deciding order and the order for costs made by the High Court are set aside. There will be no order as to costs at all levels and the deposit is to be refunded to the appellants.